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E-Update

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Four Recessions, One Big Downturn

It's finally dawning on policy-makers and investors: This recession is different and this year's stock market crash confirmed it. What makes this recession "The Big One" is that, unlike those of the past 25 years, we are experiencing a structural impairment of the economy along with a cyclical contraction that will affect the economy and its markets for a number of years. This downturn is actually the product of four recessions, running concurrently in the Financials, Real Estate, Consumer and CAPEX (business spending) sectors. The "worst practices" of financial institutions triggered a global collapse of the credit and housing markets and froze homeowners and consumers in their tracks. Many businesses, rightfully anticipating lower consumption, have shut their checkbooks as well. The result is a deflationary spiral in the economy whose roots can be traced back to Q4 of 2007.

No one is throwing the "D" word around and rightfully so. What separates a depression from severe recession is a much longer duration of restricted credit flow coupled with abnormal increases in unemployment and equally dramatic and extended declines in investment and output by businesses. Some regions of the country, such as Detroit and the Rust Belt, may experience this as assets, services, and labor costs are re-priced to more rational levels. However, we don't see those extreme conditions spreading beyond pockets within the broader US and Global economies. We view the current impairments to the credit system as temporary and the government's policy response as appropriate, though in need of some fine-tuning. While doing a good job of providing capital and liquidity to Wall Street, they've not stimulated the flow of credit on Main Street. Overlooked in the early stages of TARP is the collateral that festers within the balance sheets of most financial institutions: mortgage-backed securities. In our view, the last piece of the puzzle is crafting a temporary, systematic program for modifying residential loan terms that will postpone foreclosures and allocate losses in an orderly fashion between lender and borrower. The free lunch served up to banks, brokers, and insurers under TARP won't resuscitate the system unless some leftovers fall in the direction of homeowners.

No doubt, it does sound like a free lunch for those who don't play by the rules, but what rules? There is no shortage of those decrying the death of free market capitalism as a result of the government's efforts to arrest the free-fall in the economy. However, many are the very same folk who extolled the virtues and policies of playing without rules that produced conditions ripe for the abuses that have dealt a grave blow to the financial system. The current crisis emerged within a free-market system where many thought the few, simple, long-standing rules of capital markets could be altered by financial engineering and that both institutions and participants would exercise restraint and good judgment in pursuing their self-interests. Looking back every thirty to forty years, history has shown us that not to be the case. Time and again, a new generation of investors, borrowers, and lenders learns the hard way that there is no reward gained without risk taken and that risk can take many forms and come from any direction.

Proponents of deregulation and market stimulus removed boundaries that kept the game rational. Too many thought that anything worth doing in a regulatory void was worth over-doing. As a result, the free market system overshot mere cyclical excesses and did damage to the engine of growth in the global economy. We are in need of a mechanic and there are several to choose from. Unfortunately, Congress is on the roster. That means the same folks who set the table for the current debacle now want to clean up the mess that was left. We're hopeful they'll be left on the bench. The president-elect and his team bring an impressive set of credentials to the table and all indications point to their endorsement and improvement of the currently enacted plan. We're hopeful that they will be able to distance themselves from Congress and distinguish between mere spending and making the investments required to successfully execute a recovery. Also on tap are the Fed and Treasury, committed to repairing the system and inflating the economy out of its downward spiral. They will deal with the effects of the cure later. They know better how to combat the inflation that is likely to emerge in the aftermath of this recession than they do the threat of an extended period of deflation or worse. With that off the table, our game of free-market capitalism can resume. Hopefully, with lines redrawn on the field and a minimum of refereeing, just enough to let the old rules determine the outcome of the game.

2009: A Kitchen Sink Year and a Different Type of Recovery

Because of the structural damage to the financial system and reduced credit flow, most economists are predicting a severe recession extending through 2009. We're happy to see expectations finally catching up to reality. That is a painful, though necessary part of the recovery process. Of course, this means there will be no shortage of bad economic data coming down the road. This provides the perfect opportunity for corporations to also throw in the kitchen sink when writing down assets and reducing earnings expectations. We hold a strong conviction that negative expectations will overshoot the data trough that will form in '09 and the equity markets will begin looking up and out to better comparisons in a post-recession environment. More often than not, market trends change when investor expectations overshoot actual results.

Since this is not your run-of-the-mill recession, we are looking for a different type of recovery too. Because of the time required to repair structural defects in the financial system and the attention that will be paid by the Fed to inflation in the future, it's likely we'll experience a slow, low-growth recovery in the economy that could stretch out for a number of years. That could translate to a low-growth environment for equities following a celebratory rally by a stock market seeing the bottom in the rear view mirror. If the prior consumer recession and recovery was any indication, we are likely to see the spread between equity and fixed returns narrow much like it did between 1975 and 1982 when buy and hold indexers realized flat returns. Does anyone out there remember 15+% returns from T-Bills?

This means that equity investors will have to build bigger divergences from the indexes into their portfolios and be flexible with regard to their investment horizon. They will also have to position fixed income securities in the form of corporate and convertible bonds, preferred stocks, REITs, and other higher dividend issues to enhance their total portfolio return. Investors will have to strike an optimal balance between value, growth, and income issues as well as selectively overweight sectors expected to lead the market through its recovery. We expect the stock market of the next half-decade to reward those who make good decisions as to <u>where</u>, <u>what,</u> and <u>for how long</u> to invest across a variety of investment classes. Those who simply choose to ride along with the indexes are likely to be disappointed by returns that we believe will fall short of the historical average.

Our Wish List for 2009

It's a short one:

⇒ A program enacted to stabilize the mortgage-backed collateral held by financial institutions and get credit flowing.

⇒ The short sale rules that served investors so well for so many decades are reinstated. It's simple: Require short sellers to borrow stock and sell on an up-tick.

⇒ Make mark to market rules relevant to institutions holding mortgage-backed securities. Allow the liability to be amortized over the expected holding period of the instrument.

⇒ See NYU economist Nouriel Roubini and Oppenheimer's Meredith Whitney turn bullish on the economy and the Financials.

And finally, Good Health and Good Cheer to you and your family for the New Year

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